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INVESTMENT MANAGEMENT

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Dear Mr. Tyle:

We are writing to you to outline the views of the Division of Investment Management on certain legal issues arising from the participation of mutual funds in "fund supermarkets." As you know, fund supermarkets are an increasingly popular means through which investors can buy and redeem shares of mutual funds. As of late last year, approximately \$79 billion had been invested in mutual funds through no-transaction-fee fund supermarkets, an increase of over 750% during the prior five years.¹

In a typical fund supermarket, the sponsor of the program -- a broker-dealer or other institution -- makes available various services to a participating fund and its shareholders. The sponsor offers a menu of services including: establishing, maintaining, and processing changes in shareholder accounts; communicating with shareholders; preparing account statements and confirmations; and providing distribution services on behalf of, or with, the fund. For the services that it provides, the sponsor charges the participating fund a fee that is calculated on the basis of the amount of assets of the fund's shareholders that is held through the program. The fee is paid by the fund, its investment adviser, an affiliate of the adviser, or a combination of all three entities.

The Commission's Office of Compliance Inspections and Examinations ("OCIE") recently conducted a review of fund supermarkets and several brokerage firms that sponsor fund supermarket programs. The review revealed that different funds participating in the programs generally received the same

¹ Sandra Block, *Super-Marketing Mutual Funds Competition Increases with One-Stop Shops*, USA Today, Nov. 7, 1997, at 1B.



services from program sponsors, although the funds characterized the services differently and paid for those services in different ways. Some funds, for example, characterized all of the services that they received as distribution-related in nature and paid for those services through plans of distribution adopted pursuant to rule 12b-1 under the Investment Company Act of 1940. Other funds characterized a portion of the services that they received as administrative in nature and paid for those services outside of rule 12b-1 plans. In some cases, advisers or their affiliates paid a portion of the fee.

In the Division's view, payments of fees for participating in fund supermarkets may be made pursuant to or outside of rule 12b-1 plans, depending on the purpose of the payments and the party making the payment. Whether a fund's payment of part or all of a supermarket fee must be made pursuant to a rule 12b-1 plan depends on an analysis of the purpose for which the payment is made. The determination of the purpose of the payment must be made by the fund's board of directors and requires careful consideration and monitoring.

Discussed below, after an introductory section describing fund supermarkets and certain findings of the OCIE examinations, are significant issues that we believe are raised by the participation of funds in fund supermarkets. Following that discussion, we explain the Division's view of the critical role played by a fund's board of directors in overseeing the fund's participation in a fund supermarket.

Fund Supermarkets

Beginning in 1992, several broker-dealers introduced a new method for investors to purchase and redeem mutual fund shares: the fund supermarket. A fund supermarket is a program offered by a broker-dealer or other financial institution through which its customers may purchase and redeem a variety of funds, with or without paying transaction fees.

The sponsor of a fund supermarket usually charges a fee to the participating fund if the sponsor does not charge transaction fees to its customers. The fee generally ranges from .25% to .40% annually of the average net asset value of the shares of the fund held by the sponsor's customers.² This fee compensates the

² Recent press accounts have reported that the amount of these fees may be increasing. See, e.g., John Waggoner, *Schwab Trying to Raise Fees for Mutual Funds*, USA Today, April 22, 1998, at 1B. See also Goldman Sachs Investment Management Industry Group, *Asset Management in the 21st Century: New Rules, New Game*, April 1998, at 16.

sponsor for permitting the fund to participate in the fund supermarket and for providing the services used by the fund. These services can include certain administrative services to customers who purchase shares of the fund,³ and certain distribution services for the fund.⁴

Fund supermarkets have become quite popular with investors, as they provide investors with the ability to consolidate their fund holdings at different fund complexes in a single brokerage account and to receive a consolidated brokerage statement listing all fund holdings.⁵ The amount of assets invested in funds through fund supermarkets has increased significantly over the

³ In a typical fund supermarket, the sponsor offers various administrative services to its customers such as: sub-accounting; shareholder account set up and maintenance; shareholder assistance; transaction processing and settlement; preparation and distribution of account statements and transaction confirmations; payment of fund distributions; and distribution of prospectuses. If the customers invested directly in a fund instead of investing through the fund supermarket, the fund typically would pay its service providers for providing these administrative services to the customers.

⁴ Fund supermarkets differ from more traditional distribution channels in that sponsors of fund supermarkets typically do not solicit their customers to buy shares of any particular funds. Although the sponsors typically distribute prospectuses and other information for the funds that participate in the fund supermarkets, the sponsors typically make no recommendations about individual funds; they merely provide their customers with marketing and sales information for funds participating in the supermarkets. Many sponsors include marketing materials with proxy materials and other mailings to fund shareholders, a practice that provides a fund's adviser with the opportunity to "cross sell" other investment products to fund shareholders. Many sponsors also make discount advertising space available to a participating fund if the advertisement includes the telephone number of the sponsor's sales staff, rather than the fund's telephone number, for inquiries. Some sponsors conduct conferences for fee-based investment advisers to which the sponsors provide recordkeeping services. At these conferences, the sponsors allow participating funds to make presentations to the advisers about the appropriateness of the funds for the advisers' clients.

⁵ The sponsor of a fund supermarket usually holds the fund shares of each fund in which its customers invest in an omnibus account on behalf of the customers, i.e., the sponsor is the shareholder of record.

past few years.⁶ Many funds currently participate in fund supermarkets, and many financial institutions currently sponsor fund supermarkets.⁷

The OCIE Examinations

OCIE conducted its examinations of fund supermarkets for two principal reasons: (a) fund supermarkets represented a novel method for investors to purchase and redeem fund shares, which neither the Commission nor its staff had reviewed closely; and (b) the number of funds participating in fund supermarkets and the amount of assets invested through fund supermarkets had grown dramatically. The purpose of OCIE's examinations, among other things, was: to gain a better understanding of how fund supermarkets operate; to identify the services that the supermarkets offer; and to determine whether the participating funds were operating in a manner consistent with the federal securities laws. In particular, OCIE sought to determine whether funds that treated some or all of the fund supermarket fee as payment for non-distribution services were financing the distribution of their shares outside of a rule 12b-1 plan, in violation of rule 12b-1 under the Investment Company Act of 1940.

Of the funds examined, the OCIE staff found that some funds characterized all of the services that they received in supermarket programs as distribution-related and paid for them entirely through rule 12b-1 plans. Other funds characterized a portion of the fee as administrative in nature and paid a portion of the fee outside of a rule 12b-1 plan. In other cases, funds' advisers or their affiliates paid a portion of the fee.

In OCIE's discussions with the funds that were examined, these funds indicated that they participated in supermarkets in order to sell more of their shares and to increase assets under management. In essence, these funds used fund supermarkets as distribution channels through which they gained access to the customers of the supermarket sponsors. Thus, these funds concluded that at least some of the services that they received from fund supermarket sponsors were distribution services that could be paid by the funds only pursuant to rule 12b-1 plans. None of the funds that OCIE examined currently pays its entire fund supermarket fee out of its assets outside of a rule 12b-1

⁶ See supra note 1 and accompanying text.

⁷ See, e.g., Hank Ezell, *Mutual Fund Supermarkets Make Their Pitch with One-Stop Shopping*, Atlanta Constitution, September 27, 1998, at 12R. (citing a survey by the American Association of Individual Investors that lists 26 fund supermarkets).

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plan.

The OCIE staff also found during its examinations that the boards of directors of many funds that participate in fund supermarkets have determined that a portion of the fund supermarket fee is a non-distribution expense. Those boards concluded that, because fund supermarket sponsors provide administrative and other services that otherwise would be provided by the funds' service providers and paid for by the funds, the funds are able to reduce the payments that they make to their service providers. Thus, some funds treat a portion of the supermarket fee as a non-distribution expense and pay that portion out of their own assets, but not pursuant to rule 12b-1 plans. Some advisers also paid a portion of the fee. The OCIE staff found that most of these funds attempt to (a) identify the nature of the services provided by the fund supermarket sponsors that would have been provided by the funds' other service providers, and (b) calculate the amounts that the funds would have paid to those entities. Those amounts generally are used as a basis for determining the portion of the fund supermarket fee to be paid by the funds. Funds typically explained their analysis as attempting to determine the "savings" in administrative and other non-distribution fees that they realized from participating in fund supermarkets.⁸

Rule 12b-1 under the Investment Company Act

Rule 12b-1 under the Investment Company Act of 1940 permits any open-end management investment company to use its assets to pay broker-dealers and others for providing services that are primarily intended to result in the sale of the fund's shares. The rule was intended, in part, to address the potential conflicts of interest between a fund and its investment adviser that are created when a fund bears its own distribution expenses.⁹

⁸ Typically, the fund's adviser would present to the fund's board of directors a methodology for measuring the "savings" in administrative and other fees resulting from the fund's participation in the supermarket. The board typically would approve payments to the sponsor by either fixing the percentages of the fee that the fund and the adviser would pay or by approving a formula by which the adviser would determine the amount of the fund's payment each month.

⁹ When a fund pays these expenses, the fund's investment adviser is spared the cost of bearing the expenses itself, and the adviser benefits further if the fund's expenditures result in an increase in the fund's assets and a concomitant increase in advisory fees. See Bearing of Distribution Expenses by Mutual

Rule 12b-1 generally requires, among other things, that any payments by a fund in connection with the distribution of its shares must be made pursuant to a written plan, often referred to as a "rule 12b-1 plan," that has been approved by the fund's shareholders and by the fund's board of directors, including a majority of the directors who are not interested persons of the fund and who have no direct or indirect financial interest in the operation of the plan or in any agreements related to the plan ("financially independent directors").¹⁰ The requirements of the rule are designed to ensure that a fund's financially independent directors are not unduly influenced by management, are fully informed, and are able to exercise reasonable business judgment in determining whether the plan is in the best interests of the fund.

The Commission has taken steps to ensure that funds clearly disclose to investors any fees paid pursuant to rule 12b-1 plans.¹¹ Funds are required to disclose, in their prospectuses, fees paid pursuant to rule 12b-1 plans as a separate item in their fee tables, and are required to disclose certain information about those fees when describing their distribution arrangements.¹² Funds also are required to provide detailed information describing the material aspects of their rule 12b-1 plans in their statements of additional information, and must file a copy of their rule 12b-1 plans as an exhibit to their

Funds, Investment Company Act Release No. 10252 (May 23, 1978).

¹⁰ Under the rule, the plan may continue in effect for more than one year only if the directors, including a majority of the financially independent directors, annually approve the plan. The rule authorizes the shareholders, or a majority of the financially independent directors, to terminate the plan at any time. The rule also requires that a plan provide that it may not be amended to increase materially the amount to be spent for distribution without shareholder approval, and all material amendments of the plan must be approved by the financially independent directors. A fund may not adopt a rule 12b-1 plan unless the selection and nomination of the fund's independent directors are committed to the discretion of such directors.

¹¹ See Accounting for Distribution Expenses, Investment Company Act Release No. 15808 (June 12, 1987).

¹² See Form N-1A, Item 3 and Item 8(b). See also Registration Form Used by Open-End Management Investment Companies, Investment Company Act Release No. 23064 (Mar. 13, 1998) (revising the caption "12b-1 Fees" to "Distribution [and/or Service] (12b-1) Fees" to enable investors to better understand the nature of these fees).

registration statements.¹³

As noted above, many of the funds that were examined by OCIE treat all or part of the fund supermarket fee as a distribution expense and pay the fee out of their own assets pursuant to their rule 12b-1 plans. Some funds pay a portion of the fund supermarket fee out of their own assets, but not pursuant to a rule 12b-1 plan, and some of their advisers or the advisers' affiliates pay the remainder of the fee. Whether payments of fund supermarket fees must be made pursuant to rule 12b-1 primarily depends on (a) whether the payments are being made for services that are primarily intended to result in the sale of the fund's shares, and (b) whether the fund or another party is making some or all of the payments.

A. Payment of Fees by Funds Pursuant to Rule 12b-1 Plans

When a fund participates in a fund supermarket primarily to sell its shares to investors, at least part of the fee must be considered to be compensation paid to the sponsor for providing distribution services, *i.e.*, services primarily intended to result in the sale of the fund's shares. In such a case, the part of the fee paid for distribution may be paid by the fund only pursuant to a rule 12b-1 plan.

If a fund has adopted a rule 12b-1 plan, then the fund may pay for distribution expenses to the extent permitted under its plan.¹⁴ A fund that pays all of its fund supermarket fee pursuant to a rule 12b-1 plan need not determine which portion of the fee is primarily for distribution services or which portion is primarily for administrative services.

¹³ Form N-1A, Item 15(g) and Item 23(m).

¹⁴ The fund may do so regardless of whether its payment of the fees is intended to compensate the sponsor, in whole or in part, for providing non-distribution services. The Commission previously has stated that funds may pay for non-distribution expenses pursuant to rule 12b-1 plans. See Payment of Asset-Based Sales Loads by Registered Open-End Management Investment Companies, Investment Company Act Release No. 16431, at note 129 (June 13, 1988) ("Release No. 16431") (when proposing amendments to rule 12b-1, the Commission stated that "rule 12b-1 does not specifically prohibit the payment of non-distribution expenses under a 12b-1 plan..."); Charles Schwab & Co., Inc., at note 2 (pub. avail. Aug. 6, 1992). Funds, however, are not required to pay for non-distribution services pursuant to rule 12b-1 plans even if the recipient of the payment also is involved in the distribution of fund shares. See Release No. 16431, supra at note 126.

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B. Payment of Fees by Funds Outside of Rule 12b-1 Plans

If a fund has not adopted a rule 12b-1 plan, then it cannot use fund assets to pay for services that are primarily intended to result in the sale of the fund's shares. Thus, any portion of the supermarket fee that is primarily for distribution services cannot be paid out of the fund's assets. A fund that has not adopted a rule 12b-1 plan, however, may use its assets to pay a fund supermarket sponsor for services that the fund's board has determined to be non-distribution services.

C. Payment of Fees by Funds' Investment Advisers

If a fund's investment adviser makes distribution-related payments out of its own resources, rule 12b-1 generally would not apply because the payments are not being made out of fund assets.¹⁵ Thus, if a fund's investment adviser pays all of the fund supermarket fee, or the portion of the fee that is for services that are primarily intended to result in the sale of fund shares, rule 12b-1 generally would not apply.

Rule 12b-1 could apply, however, in certain cases in which the adviser makes distribution-related payments out of its own resources. As the Commission has stated, "an indirect use of fund assets for distribution would result if any allowance were made in the investment adviser's fee to provide money to finance distribution."¹⁶ Thus, for example, if a fund approved an increase in the advisory fee of its investment adviser so that the adviser could pay for distribution services for the fund, such payments could be made only pursuant to a rule 12b-1 plan. In future examinations, OCIE staff will closely scrutinize any increase in a fund's investment advisory fee that appears to be for the purpose of compensating the fund's investment adviser for paying the fund's supermarket fee.

Role of the Fund's Board of Directors

The board of directors of a fund that participates in a fund supermarket plays a critical role. The board is responsible for determining whether any portion of a fund supermarket fee paid (or to be paid) by the fund is for distribution, i.e., services primarily intended to result in the sale of fund shares. Whether

¹⁵ See Bearing of Distribution Expenses by Mutual Funds, Investment Company Act Release No. 11414 (adopting rule 12b-1) (Oct. 28, 1980) ("Release No. 11414"). See also Release No. 16431, supra note 14, at text accompanying note 124.

¹⁶ Release No. 16431, supra note 14, at text accompanying note 124.

or not any particular payment of a fund supermarket fee by a fund is for distribution services or non-distribution services is primarily a question of fact for the fund's board of directors to determine.¹⁷ This responsibility necessarily entails considering the nature of the services used by the fund or provided to the fund by the supermarket sponsor. The sponsor's characterization of the services that it offers is one factor that the board should consider in making this determination.

A fund's board could determine that the entire fund supermarket fee paid by the fund is for services that are primarily intended to result in the sale of the fund's shares. In such a case, the board could conclude, consistent with its obligations under rule 12b-1, that the entire fund supermarket fee is for distribution services and should be paid pursuant to the fund's rule 12b-1 plan.

A fund's board, on the other hand, could determine that only a portion of the fund supermarket fee paid by the fund is for distribution services. When determining whether a particular payment is for distribution or non-distribution services, the board should review both the distribution and non-distribution services provided by the fund supermarket sponsor. The board should determine whether the portion of the fund supermarket fee that is paid by the fund for non-distribution services is reasonable in relation to (a) the value of those services and the benefits received by the fund and its shareholders and (b) the payments that the fund would be required to make to another entity to perform the same services. If, for example, a fund pays a supermarket fee of .25%, and the board of directors determines that the value of the non-distribution services provided by the fund supermarket sponsor is .20%, then the board could conclude, consistent with its obligations under rule 12b-1, that the portion of the fee that is attributable to non-distribution services is .20% and that portion need not be paid by the fund pursuant to a rule 12b-1 plan.

If a fund's board determines that none of the supermarket fee was for distribution services, and the fund paid the entire fee out of its own assets,¹⁸ the Division believes that the board

¹⁷ See Release No. 16431, supra note 14, at notes 129 & 173. See also The Shareholder Services Group, Inc., at text accompanying note 5 (pub. avail. Aug. 12, 1992).

¹⁸ For example, some funds may continue to participate in fund supermarkets to obtain administrative services from the sponsors, e.g., fund supermarkets typically require participating funds to continue paying fund supermarket fees to the sponsors for continuing to provide administrative services to their

would need to be able to satisfy itself that its determination was supported by all factors relevant to its characterization of the purpose of the services. These factors would include, among others, the nature of the services provided; whether the services provide any distribution benefits; whether the services provide non-distribution related benefits and are typically provided by fund service providers; the costs that the fund could reasonably be expected to incur for comparable services if provided by another party, relative to the total amount of the supermarket fee; and the characterization of the services by the fund supermarket sponsor. In future examinations, OCIE staff will closely scrutinize the analysis conducted by such a fund's board of directors.

As part of its assessment of a fund's participation in a fund supermarket, the fund's board of directors should examine any supermarket fees that are paid by the fund's investment adviser. As the Commission has stated:

[W]hen an adviser finances the distribution of fund shares, the directors of the fund, in discharging their responsibilities in connection with the approval of the advisory contract, must satisfy themselves either that the management fee is not a conduit for the indirect use of the fund's assets for distribution, or that the fund has complied with rule 12b-1.... [T]here is no indirect use of fund assets for distribution if the adviser makes distribution-related payments out of its own resources.... [I]t is appropriate to ... view such expenditures as having been made from the adviser's profits under the contract. To the extent that such profits are "legitimate" or "not excessive," *i.e.*, not in violation of section 36 of the Act, no indirect payment for distribution occurs.... If the fund's directors are satisfied that any distribution payments by the adviser are made out of its own resources (including, but not limited to, the profits under the advisory contract), the directors may reasonably conclude that the advisory contract is not a conduit for the payment of distribution expenses. If such a conclusion is reached, the fund need not adopt a 12b-1 plan to cover distribution payments borne by the adviser.¹⁹

customers who purchased shares of the funds, even if the funds discontinue selling their shares through the fund supermarkets.

¹⁹ See Release No. 16431, *supra* note 14, at text accompanying notes 124-29 (footnotes omitted). See also Release No. 11414, *supra* note 15.

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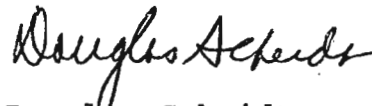
The fund's board should periodically review its determinations to ensure that any payments by the fund or its adviser to a fund supermarket sponsor are consistent with rule 12b-1.²⁰ The board also should ensure that the fund is not paying the sponsor for services that duplicate services already being provided to the fund. In light of the importance of the board's role in overseeing a fund's participation in a fund supermarket, OCIE staff will closely review the actions taken by boards of funds that participate in fund supermarkets.

Conclusion

Rule 12b-1 does not prohibit funds from paying fund supermarket fees in different ways and for different purposes. A fund's board of directors, however, has the responsibility to determine whether any portion of a fund supermarket fee that is directly or indirectly paid by the fund is primarily for distribution and, if so, to ensure that any such payments are made pursuant to a rule 12b-1 plan.

We would appreciate your informing your members of the views expressed in this letter. If you have any questions or require additional information about these issues, please contact me or Mercer Bullard, Assistant Chief Counsel, at (202) 942-0660. Thank you for your assistance.

Very truly yours,



Douglas Scheidt
Associate Director and
Chief Counsel

²⁰ We also note that any portion of a fund supermarket fee that is paid by a fund and allocated to asset-based sales charges or service fees must comply with rules of the National Association of Securities Dealers, Inc. ("NASD"). Rule 2830(d) of the Conduct Rules of the NASD imposes aggregate limits on the front-end, deferred and asset-based sales charges paid by a fund distributed through an NASD member. The rule also limits the annual amount of "service fees" that such a fund may pay, and prohibits a fund from describing itself as "no-load" if the fund's total charges to provide for asset-based sales charges and/or service fees exceed .25% of the fund's average annual net assets. See also Investment Company Institute (pub. avail. Aug. 22, 1994).

